Current Liabilities and Contingencies

CONTINGENCIES

FASB Statement of Financial Accounting Standards No. 5 defines a contingency “as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.”

Gain Contingencies
Gain contingencies are never recognized until they actually occur. Typically there is no mention of a gain contingency in the financial statements. The only place any mention might be made would be in the notes to the financial statements.

Loss Contingencies
There is a range of probabilities within which a contingent liability might occur. The FASB has defined the following terms in an attempt to define this range.

- **Probable** - the future event or events are likely to occur
- **Reasonably possible** - the chance of the future event or events occurring is more than remote but less than likely
- **Remote** - the chance of the future event or events occurring is slight

A contingent liability should be booked if the following two conditions are met.
1. As of the date of the financial statement it was probable that a liability has been incurred, and
2. The amount of the loss can be reasonably estimated

Common loss contingencies are:

A. Litigation, Claims, and Assessments
   Three factors must be considered in evaluating whether a contingent liability should be reported on the balance sheet
   1. The underlying cause of the action must have occurred before the balance sheet date
   2. An unfavorable outcome of the action must be probable
   3. The entity must be able to make a reasonable estimate of the amount of the loss

B. Guarantee and Warranty Costs
   A product guarantee or warranty is an obligation on the part of the seller to make good regarding any deficiency of quantity, quality or performance of the product. There are two methods of accounting for warranty costs.

   1. Cash Basis
      If the warrant liability is not accrued in the year of sale the cash basis must be used. This method requires a charge to warranty expense when the event occurs that requires the company to incur costs to make good on the warranty. The entity may use the cash basis method only if
      a) It is not probable that a liability has been incurred on or before the balance sheet date, or
      b) The amount of the contingent liability cannot be reasonably estimated
Current Liabilities and Contingencies

(2) Accrual Basis

The accrual basis method is GAAP. This method requires that the warranty costs be charged to operating expense in the year of sale. The textbook identifies this at the expense warranty approach.

**Example:** Spencer Company sells 100 dog runs for $500 each during 2004. The dog runs have two-year warrants covering parts and labor. Based on past experience, management estimates that the average warranty costs per dog run will be $25. The company incurs $1,000 in warrant costs in 2004 and $1,200 in 2005. The following journal entries reflect the sale of the dog runs and accrual of the warrant liability during 2004.

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$50,000</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>$50,000</td>
<td></td>
</tr>
<tr>
<td>To record sales of dog runs for 2004</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Analysis of sales:**

<table>
<thead>
<tr>
<th>Selling price per unit</th>
<th>$500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of units sold</td>
<td>100</td>
</tr>
<tr>
<td>Sales</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warranty expense</td>
<td>$2,500</td>
<td></td>
</tr>
<tr>
<td>Estimated liability under warranties</td>
<td>$2,500</td>
<td></td>
</tr>
<tr>
<td>To accrue warranty expense associated with 2004 sales</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Analysis of warranty expense:**

<table>
<thead>
<tr>
<th>Estimated warranty cost per unit</th>
<th>$25</th>
</tr>
</thead>
<tbody>
<tr>
<td>Units sold</td>
<td>100</td>
</tr>
<tr>
<td>Estimated warranty expense</td>
<td>$2,500</td>
</tr>
</tbody>
</table>

The actual costs incurred and paid during 2004 were $1,000. The following journal records warranty costs incurred during the year.

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated liability under warranties</td>
<td>$1,000</td>
<td></td>
</tr>
<tr>
<td>Cash, inventory or accrued payroll</td>
<td>$1,000</td>
<td></td>
</tr>
<tr>
<td>To recognize warranty costs incurred during 2004</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Current Liabilities and Contingencies

The following T-Account analysis shows the estimated liability that would be presented in the balance sheet at December 31, 2004.

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accrual of estimate during for 2004</td>
<td>$2,500</td>
<td></td>
</tr>
<tr>
<td>Actual warranty costs incurred in 2004</td>
<td>$1,000</td>
<td>$1,500</td>
</tr>
<tr>
<td>Ending balance, 12/31/04</td>
<td></td>
<td>$1,500</td>
</tr>
</tbody>
</table>

The actual costs incurred and paid during 2005 were $1,200. The following journal records warranty costs incurred during the year.

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated liability under warranties</td>
<td>$1,200</td>
<td>$1,200</td>
</tr>
<tr>
<td>Cash, inventory or accrued payroll</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To recognize warranty costs incurred during 2005</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The following T-Account analysis shows the estimated liability that would be presented in the balance sheet at December 31, 2005.

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accrual of estimate during for 2004</td>
<td>$1,500</td>
<td></td>
</tr>
<tr>
<td>Actual warranty costs incurred in 2004</td>
<td>$1,200</td>
<td>$300</td>
</tr>
<tr>
<td>Ending balance, 12/31/05</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

If warranties are sold separately from the product then the entity will use the sales warranty approach. The revenue on the sale of product warranties sold separately is deferred and amortized over the life of the warranty on a straight-line basis.

C. Premiums and Coupons

Premiums and coupons are considered a contingent liability. This contingent liability must be estimated and reflected in the balance sheet. The entity normally purchases the premiums, which are used over subsequent accounting periods.

Example: Spencer Company includes a coupon in each 10-pound bag of dog food giving the purchaser the opportunity to receive a free custom dog tag. The custom dog tags cost Spencer Company $1. The Company will incur an additional $0.50 of cost for engraving and shipping when the customer redeems the coupon. During 2004 Spencer Company purchased 20,000 dog tags. The Company sold 100,000 bags of dog food for $10 each. The company expects 10% of the coupons to be redeemed. During 2004, customers redeemed 2,500 of the coupons. The following journal entries reflect the purchase of the dog tags, sales made...
Current Liabilities and Contingencies

during 2002, premium expense associated with the sales and the cost of the premiums redeemed.

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, premiums (dog tags)</td>
<td>$20,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>$20,000</td>
</tr>
</tbody>
</table>

To record the purchase of dog tags as a premiums

Analysis of inventory, premiums:

| Price per dog tax | $1 |
| Number of dog tags purchased | 20,000 |
| Inventory, premiums | $20,000 |

Analysis of sales:

| Selling price per 10-pound bag of dog food | $10 |
| Bags sold | 100,000 |
| Sales | $1,000,000 |

Analysis of premium expense:

| Bags of dog food sold | 100,000 |
| Estimated percentage of coupon redemptions | 10% |
| Estimated percentage of coupons redeemed | 10,000 |
| Cost per coupon | $1.50 |
| Premium expense | $15,000 |

Analysis of premium expense:

| Estimated liability for premiums | $3,750 |
| Inventory, premiums | $2,500 |
| Cash | $1,250 |

To record the redemption of premiums during 2004
Current Liabilities and Contingencies

**Analysis of redemption of premiums:**

- Coupons redeemed: 2,500
- Cost per premium (dog tag): $1.00
- Inventory of premiums, (dog tags): $2,500
- Cost of engraving and shipping: $0.50
- Cash paid for engraving and shipping: 1,250
- Charge to estimated liability for premiums: $3,750

The following T-Account analysis shows the estimated liability that would be presented in the balance sheet at December 31, 2004.

D. Environmental Liabilities
At the present time most entities claim that the contingent liability associated with environmental waste is not reasonably estimable. Therefore the only disclosure is usually in the notes to the financial statements. This situation may change in the next few years as claims are litigated against the worst polluters.

E. Self-Insurance
An entity may purchase insurance for many potential future liability exposures. Such insurance is an operating expense as incurred. Many larger companies self-insure some or all of certain classes of liability exposures. The contingent liability associated with these exposures is not accrued or disclosed in the financial statements. Such exposure is considered part of the normal business risk of the entity.

F. Subsequent Events
A subsequent event is an event that occurs prior to the end of the fiscal year and creates a liability. When the liability is created and possibly at the end of the fiscal year the company may not be able to determine the amount of the liability. If prior to the issuance of the financial statements it becomes possible to determine the amount of the liability, the company is required to accrue the liability in its year end financial statements.

If an event takes place after the fiscal year end that creates a liability, this is not a subsequent event and the amount of the liability is not accrued in the financial statements. If the event is material, a description and estimated amount would be disclosed in the notes to the financial statements.